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BT Pension Scheme

Ofcom Strategic Review of Digital Communications: Strengthening Openreach's Strategic and Operational Independence

Ofcom's Proposal for Comment – Response of the Trustee of The BT Pension Scheme

4 October 2016

CONTENTS

GLOSSARY

2014 Valuation	Means the last full actuarial valuation of the Scheme, carried out as at 30 June 2014
2014 Funding Agreements	Has the meaning given in paragraph 4.35
BT Group or **BT**	Means BT Group plc and its subsidiaries and subsidiary undertakings
BT plc	Means British Telecommunications plc, being the main operating company of the BT Group, the principal employer of the Scheme and the primary entity to which the Scheme has legal recourse for funding purposes
BT Proposal	Means the BT Group's proposal for the enhanced functional separation of Openreach, as set out in "*Strengthening Openreach's independence: BT's Notification to Ofcom under section 89C of the Communications Act 2003 and Application to vary its Undertakings given to Ofcom pursuant to Section 154 of the Enterprise Act 2001*", published 18 July 2016
Crown Guarantee	Means the guarantee provided under section 68 of the Telecommunications Act 1984
Customer Purpose	Has the meaning given in paragraph 4.30
Employer Covenant	Means the financial strength of the entities to which the Scheme has legal recourse relative to their funding obligations to the Scheme and their willingness and ability to make payments as and when required to fund the Scheme's benefit obligations
Ofcom Document	Means the document "*Strengthening Openreach's strategic and operational independence, Proposal for comment*", published by Ofcom on 26 July 2016
Ofcom Proposal	Means Ofcom's Proposal for the legal separation of Openreach, as set out in the Ofcom Document
Openreach	Means the Openreach business currently carried on by BT plc
Openreach Board	Means the Openreach Co board of directors, as described in the Ofcom Proposal
Openreach Co	Means the new wholly-owned subsidiary of BT plc which would carry out the Openreach business, as described in the Ofcom Proposal
Penfida	Means Penfida Limited, the Trustee's advisor on matters relating to the Employer Covenant
Pension Protection Fund	Means the UK fund established to pay compensation to members of eligible defined benefit pension schemes when there is a qualifying insolvency event in relation to the employer

	and where there are insufficient assets in the pension scheme to cover Pension Protection Fund levels of compensation
Pensions Regulator	Means the UK regulator of work-based pension schemes
Regulatory Purpose	Has the meaning given in paragraph 4.30
Scheme or **BTPS**	Means the BT Pension Scheme
Scheme Actuary	Means the individual appointed under section 47 of the Pensions Act 1995 by the Trustee to assess and report on the financial security of the benefits accrued under the Scheme from time to time
Scheme Rules	Means the rules which determine how and when benefits are paid and provide the governance and management structure for the Scheme
Shareholder Benefit Purpose	Has the meaning given in paragraph 4.30
Technical Provisions	Means the amount of assets determined from time to time as being required to make provision for the accrued liabilities of the Scheme
Trust Deed	Means the deed which established the Scheme under irrecoverable trusts and having as its primary purpose the securing of pensions and other benefits for some or all of the present and future employees of British Telecommunications, with effect from 31 March 1983
Trustee or **we**	Means BT Pension Scheme Trustees Limited, being the trustee of The BT Pension Scheme

1. EXECUTIVE SUMMARY

1.1 This submission sets out the response of the Trustee to Ofcom's proposal for the legal separation of BT plc's Openreach division, as set out in the Ofcom Document "*Strengthening Openreach's strategic and operational independence, Proposal for comment*", published on 26 July 2016.

1.2 Ofcom has set out in the Ofcom Document its preferred model to secure greater independence for Openreach, namely that Openreach should be established as a wholly-owned subsidiary of BT plc, with its own purpose, board of directors and governance arrangements. However it has also noted the need, in considering the costs and therefore the proportionality of these proposals, to take into account the impact of the proposals on the BTPS: "*If our proposal increased the BT Pension Scheme Trustees' assessment of the risks facing the scheme, they may require additional cash contributions to mitigate these risks. Such contributions could be significant and could represent the largest single cost caused by our proposals.*"[1]

1.3 In light of these comments the Trustee has evaluated the Ofcom Proposal carefully and has taken extensive advice from the Scheme's lawyers, covenant, investment and actuarial advisors, and sought the views of the Scheme Actuary. This response has been prepared in conjunction with the Scheme's advisors.

1.4 The Trustee estimates that, as at 30 June 2016, the Scheme had a shortfall in the value of its assets as compared to its liabilities of around £[CONFIDENTIAL]bn (using assumptions consistent with those used in the 2014 Valuation). The Scheme therefore has a very significant shortfall. [CONFIDENTIAL

]. Furthermore, the estimated shortfall in the Scheme on a solvency basis as at 30 June 2016 was c.£[CONFIDENTIAL]bn (see paragraph 3.9). The BTPS is therefore a material creditor of BT plc. The Trustee and the Scheme Actuary need to have confidence that the Scheme retains, via the Employer Covenant, legally enforceable recourse to ongoing cash flows and assets which will, in the long term, be sufficient to ensure that the benefits due to the Scheme's members are paid in full.

1.5 The Trustee takes an integrated approach to the management of risk in the Scheme. The Trustee therefore invests the assets of the Scheme on a basis that is consistent with funding a defined level of benefits within an acceptable level of risk, having regard to the Employer Covenant provided to the Scheme by BT plc. In particular, the Trustee to date, due to the strength of the Employer Covenant, has been content to take a degree of investment risk in the Scheme in the expectation of generating higher returns. The level of investment risk would need to be reviewed following any significant weakening of the Employer Covenant.

[1] Paragraph 1.23 of the Ofcom Document.

The Ofcom Proposal would materially compromise the Employer Covenant

1.6 The Trustee considers Openreach to be a particularly important component of the Employer Covenant. The Scheme's covenant advisors estimate that Openreach contributes around one third to their assessment of the value of the Employer Covenant (see paragraph 3.19) and generates approximately one third of BT plc's profits and operating cash flow. In addition, the Trustee believes that Openreach's revenues are more stable and reliable than those generated by BT plc's other businesses. This is taken into account in assessing the overall value of the Employer Covenant and Openreach's contribution to it.

1.7 We have identified seven aspects of the Ofcom Proposal that have the potential to materially damage the strength of the Employer Covenant and/or otherwise create increased risks for the Scheme and its members:

(i) The fact that the Scheme would be structurally subordinated to the investment and business priorities of Openreach Co, and in particular would lose direct recourse to Openreach Co assets;

(ii) The potential for alienation of cash flows, including in particular the loss of recourse to cash flows;

(iii) The potential for long term loss of value to the BT Group as a result of the one-off and ongoing costs of restructuring, including the loss of efficiencies;

(iv) Uncertainty around the proposed governance arrangements, including how the proposed duties or decision-making processes of the Openreach Board would interact with the Scheme's long term need to become and remain fully funded on an appropriate basis;

(v) The proposed movement of employees, including the implications for c.17,000 Openreach employees who are active members of the BTPS if they cease to be eligible to accrue ongoing benefits in the BTPS;

(vi) The potential for an alteration in the scope and/or effectiveness of the Crown Guarantee; and

(vii) The possibility of further regulatory intervention which in itself creates uncertainty and will reduce the Trustee's willingness to rely on the Employer Covenant.

1.8 For the reasons set out in this paper the Trustee's view, after careful consideration of the proposals and in light of the advice that it has received, is that Ofcom is correct to have had concerns that the Ofcom Proposal could increase the risks facing the Scheme. The Trustee's conclusion is that the Ofcom Proposal in its current form would have a material adverse impact on the confidence of the Trustee in the Employer Covenant and the security it provides to the Scheme both today and in the future. With reduced ability to rely on the Employer Covenant, the Trustee would be obliged to reconsider its investment strategy and the degree of prudence required in valuation assumptions. Such actions would most likely result in a worsening of Scheme funding and material additional pension costs for BT plc.

1.9 Based on our current understanding of the Ofcom Proposal, the Trustee believes it could result in significant detriment to the Employer Covenant and this would necessitate the Trustee taking a less risky approach. The advice received by the Trustee indicates that, on a standalone basis and without mitigation, this could result in an increase to the Technical Provisions deficit to above £[CONFIDENTIAL]bn.

1.10 Further details are set out in section 4.

These risks cannot be fully mitigated

1.11 We note that Ofcom states, as regards the potential implications of the Ofcom Proposal for the Scheme, that "*there are a number of remedial actions available that would be consistent with our preferred model.*"[2]

1.12 We have considered in detail the mitigants suggested by Ofcom to see how far it is possible, in the specific circumstances of the Scheme, to arrive at a "risk-neutral" outcome for the Scheme and Scheme members. We have also considered with our advisors some additional alternative approaches to risk mitigation.

1.13 In summary, our conclusion is that although some of the mitigants could have an impact on the risks faced by the Scheme, none of these approaches, alone or in combination, would mitigate fully the increased risk to the Scheme resulting from the Ofcom Proposal. To place the Scheme in the same position as it is in today from a recourse perspective, the Trustee would require nothing less than to have an unlimited primary joint and several obligation on Openreach Co co-extensive with any and all of BT plc's obligations and liabilities to the Scheme, structured so as to in no way compromise the Crown Guarantee. Imposing joint and several liability on the new Openreach Co for a pension plan with a c.£[CONFIDENTIAL]bn funding deficit and a material level of ongoing investment risk would clearly have a significant financial impact on the new Openreach Co; there would also be significant complications associated with any changes to the Crown Guarantee.

1.14 However, even if those matters could be overcome, the potential consequential impacts of such a mechanism on the broader Employer Covenant would mean that overall the Ofcom Proposal would still not be "risk neutral". We expect that if material mitigants are proposed then BT plc would face numerous commercial challenges in terms of demands from other creditors for similar protections, and the consequential restrictions on future operational and financing flexibility. Commercial challenges such as these would also be of concern to the Trustee: it is important for the ongoing security of the Scheme that the BT Group is able to raise finance so that it can fund its obligations to the Scheme out of more than just the cash flow generated from its business. Maintenance by the Trustee of its legal access to Openreach revenues and assets would be of limited value if the

[2] Paragraph 1.29 of the Ofcom Document.

broader value of the Employer Covenant is impaired. Such impairment could of itself result in the need for increased deficit contributions.

1.15 We note that the Scheme, the extent of its dependence on BT plc and Openreach, and the potential impact, therefore, of the Ofcom Proposal on the Scheme, is unique in many respects. The Scheme is the largest private sector defined benefit pension scheme by reported liabilities in the UK and we do not believe that there is any other UK private sector scheme with reported liabilities approaching £[CONFIDENTIAL]bn that depends on a single sponsor for its Employer Covenant in the way that the Scheme is dependent on BT plc. It cannot be assumed that measures that may be sufficient or appropriate in other cases would be sufficient or appropriate in this case.

1.16 It is therefore unlikely that mitigation approaches that are common in the sub-£10bn liability scheme category (which would themselves not be viewed as "small") can readily be scaled up to provide the same comfort in relation to a scheme which is [CONFIDENTIAL] times that size ([CONFIDENTIAL]). We believe that the Scheme is qualitatively, rather than just quantitatively, different from these smaller schemes.

1.17 Further details on these issues are set out in section 5.

There would also be practical difficulties with implementing any mitigants

1.18 We also foresee considerable difficulties in securing many of the mitigants that have been identified.

1.19 Ofcom recognises that detailed negotiation between BT and the Trustee would be required. The Trustee would also expect Government to engage with us on any changes that may be proposed to the Crown Guarantee.

1.20 In any such negotiations, BT plc will be obliged to have regard to the interests of all its stakeholders and the interests of BT plc and the Government position will not necessarily align with the interests of the Scheme. The Trustee would be unable to anticipate securing a favourable outcome at any point prior to the conclusion of such negotiations. It is therefore important that mitigants are only taken into account in assessing proportionality if they are made an integrated part of the proposed arrangements and are "baked in", with any necessary third party consents obtained and details agreed, before any final decision is taken to proceed.

1.21 Further details are set out in section 6.

Ofcom should take into account the potential for increased pension costs and risks when assessing its proposals

1.22 The Trustee appreciates Ofcom's statement that it is not Ofcom's "*intention to create disproportionate costs, or to undermine BT's ability to support and meet its liabilities*"[3] but is currently concerned that this will be the effect of the Ofcom Proposal.

1.23 Anything that increases the risks facing the Scheme, including a diminution in the value or resilience of the Employer Covenant, might require the Trustee to take a more cautious approach to the funding of the Scheme. The Trustee would need to consider in detail, and in light of the wider economic circumstances, the appropriate response (which could include, for example, adjusting the current investment strategy to reduce the level of risk or to adjust the longer term investment strategy to accelerate the reduction of risk in the portfolio).

1.24 Given the potential for material detriment to the Employer Covenant if Ofcom were to proceed with its proposals, our lack of confidence that adequate viable mitigants can be found, and the ongoing uncertainty that this would create, the Trustee would be likely to call an immediate formal valuation to ensure the Scheme's funding needs are established as quickly as possible and a revised legally binding schedule of contributions is put in place with BT plc. Such urgent action would be necessitated to protect the Scheme and the interests of our members.

1.25 While it is not possible at this stage to quantify precisely the overall impact in terms of increased pension contribution obligations on BT plc (and Openreach Co), the advice that the Trustee has received indicates that, on a standalone basis and without mitigation, a deficit of over £[CONFIDENTIAL]bn could result. In considering the proportionality and merits of its proposal, Ofcom should therefore, in our view, factor in the potential for material additional costs as a result of the impact of these proposals on the position of the BTPS, which would in turn inevitably impact on the ability of BT plc and the wider BT Group to invest in other areas of its business.

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[3] Paragraph 1.30 of the Ofcom Document.

2. BACKGROUND & FRAMEWORK

2.1 We set out below some key components of the framework within which the Trustee must manage the Scheme. To a large extent, this determines the Trustee's responsibilities, actions and considerations when carrying out its duties and is the framework against which the Trustee has considered the implications of the Ofcom Proposal as set out in Section 4 and its consideration of potential mitigants in Section 5.

Overview of the BTPS

2.2 The BTPS is the UK's largest private sector defined benefit pension scheme. The Trustee estimates that, as at 30 June 2016, the Scheme was paying over £2bn a year in pension payments, with the average annual pension received by our pensioners being c.£12,000. As of 30 June 2016, the Scheme's membership comprised around 34,000 active members (being current employees of the BT Group), 68,000 deferred members (being ex-BT employees who have not yet drawn their pension) and 201,000 pensioners, including dependants of former BT employees.

2.3 As a defined benefit pension scheme, each member's benefit entitlement in the Scheme is calculated by reference to that member's pensionable salary and length of pensionable service, rather than by reference to the amount of contributions made to the Scheme by, or on behalf of, that member. Consequently, the investment and longevity risks inherent in ensuring that there are sufficient funds to meet the cost of providing pensions to members and their dependants rests with the Scheme and not with the member. To the extent that the Scheme has insufficient funds to cover all of the benefits that may be payable, then the Scheme is a creditor of, primarily, BT plc for the shortfall and is reliant on BT plc's ability and willingness to fund its ongoing obligations to the Scheme (i.e. its covenant).

2.4 The cash flow generating ability and asset base of BT plc, which currently owns and operates, among other things, Openreach and all the Openreach assets, and its ability to make payments as and when required, is therefore critically important to the Scheme (and its 303,000 members). Furthermore, while we do not have exact information, we estimate that around half of the Scheme's active members work for Openreach, making the Ofcom Proposal directly relevant to the future pension payments of nearly 17,000 people and increasing uncertainty for the other 286,000 members.

Legislative and regulatory framework

2.5 The Scheme was set up under the Trust Deed and is governed by the Scheme Rules, which determine how and when benefits are paid and provide the governance and management structure for the Scheme. The Scheme also operates having regard to UK legislation and regulation.

2.6 The Pensions Act 2004 and the Scheme Rules include requirements to ensure that a scheme is sufficiently funded to pay the benefits to which members are entitled and provide for any shortfall to be met by the sponsoring employer.

2.7 The Trustee has a fiduciary duty to strive to ensure that members receive their full benefits as they fall due under the Scheme, in accordance with the Trust Deed and Scheme Rules and legislative requirements more generally. As already noted by Ofcom in the Ofcom Proposal, given their role, "*the trustees are likely to be cautious in applying their judgement*".[4]

2.8 In addition, the Pensions Regulator provides extensive guidance to trustees on their role and responsibilities and on managing the funding position of their pension schemes. In its most recent code of practice on the funding of defined benefit pension schemes, the Pensions Regulator stresses the importance to a pension scheme of a financially robust sponsoring company and the need to have careful regard to the current and ongoing strength of the sponsoring employer when evaluating the funding needs of the pension scheme.[5]

The Crown Guarantee

2.9 When BT plc was privatised in 1984, the Government provided a guarantee of BT plc's obligations to the Scheme – set out in the Telecommunications Act 1984. The Crown Guarantee is only relevant on a winding up of BT plc and, in such circumstances, would cover BT plc's obligations to ensure the Scheme has sufficient funds to pay the accrued benefits (other than some relatively minor exclusions in relation to certain liabilities).

2.10 It is important to understand that the Crown Guarantee does not cover the liabilities of the Scheme itself and/or the benefits of particular members. It relates only to the obligations of BT plc to the Scheme and, consequently, the Crown Guarantee only remains in place for as long as, and to the extent that, BT plc itself continues to have the obligation to support the Scheme.

2.11 The Crown Guarantee is only applicable on a winding up of BT plc and its existence is not taken into account in assessing the funding position of the Scheme from time to time, or in agreeing any recovery plan that might be needed to address any shortfall in the Scheme. Nevertheless the Crown Guarantee is, without doubt, a significant protection for members of the Scheme in the event of the insolvency of BT plc. While such an event is currently highly unlikely, it may be more than 70 years until the last benefit is paid by the Scheme, during which time much could happen to BT plc.

2.12 The Crown Guarantee operates for the benefit of all members of the BTPS as any monies paid by the Government in respect of it would serve to increase the total assets of the Scheme from which all members' benefits are funded. Maintaining its full scope, effectiveness and applicability is therefore of critical importance to the Trustee and to all Scheme members.

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[4] Paragraph 5.18 of the Ofcom Document.

[5] http://www.thepensionsregulator.gov.uk/codes/code-funding-defined-benefits, see section on Employer Covenant considerations, pages 22-27.

Requirement for an actuarial valuation

2.13 Under the Scheme Rules, and as per the legislative requirements applying to most UK pension schemes, the Trustee obtains actuarial valuations of the Scheme at least once every three years. In the event that there are insufficient assets to cover the Scheme's Technical Provisions at the valuation date, a schedule of deficit recovery payments to eliminate the shortfall (known as a "recovery plan") is put in place.

2.14 In addition, the actuarial valuation will determine the regular contributions required to be paid to the Scheme to meet the ongoing cost of its administration and ongoing benefit accrual.

2.15 It is important to note the role of the Scheme Actuary in actuarial valuations of the Scheme. Historically, the rules of a number of pension schemes provided for the scheme actuary to determine the level of contributions that should be paid by a sponsoring employer to address any deficit in the relevant scheme. However, in 2005, regulatory changes introduced a requirement for most trustees to negotiate and agree recovery plans with sponsoring employers.[6] Even so, for schemes whose rules require the actuary to set the rate of contributions, the relevant regulations still require the actuary to certify that the contributions agreed between the trustee and the sponsoring employer are no lower than the actuary would independently have set.[7]

2.16 The Scheme Rules are such that a certificate has been required from the Scheme Actuary confirming the appropriateness of the schedule of contributions agreed between the Trustee and BT plc for any valuations carried out under Part 3 of the Pensions Act 2004.

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[6] Part 3 of the Pensions Act 2004.

[7] Schedule 2 to the Occupational Pension Schemes (Scheme Funding) Regulations 2005.

3. THE CURRENT POSITION

Current funding position of the Scheme

3.1 In line with the legislative requirements, the assumptions used to calculate the Technical Provisions are chosen to be appropriately prudent, including, where considered appropriate, a suitable margin for adverse deviation.

3.2 Under the current Statement of Funding Principles of the BTPS, which was put in place as part of the 2014 Valuation, the assumed rate of return on the Scheme's assets for funding purposes has regard to the Scheme's investment strategy and how this is anticipated to change in future years, reflecting the Trustee's desire to reduce investment risk over time, including significantly increasing the level of interest rate and inflation hedging in the shorter term and targeting a substantially lower risk investment strategy in the long term.

3.3 It is intended that individual assumptions will be chosen with a level of prudence such that, when taken together, the Trustee has an appropriate level of confidence that the resulting funding target will prove adequate to pay benefits as they fall due. In making this assessment, the Trustee considers the Scheme's estimated solvency position, the relative strength of the Employer Covenant and other longer term measures of risk.

3.4 The results of the 2014 Valuation were as follows:

Market value of assets	£40.35bn
Technical Provisions	£47.39bn
Funding shortfall	£7.04bn

3.5 Given the financial strength of BT plc and its ongoing commitment to the Scheme, the Trustee has historically considered that a degree of investment risk could be taken in the expectation of generating higher returns, particularly in the short to medium term when it has clear visibility over the Employer Covenant. For the purpose of the 2014 Valuation, an allowance for higher investment returns was taken into account in calculating the Scheme's Technical Provisions. In order to repair the £7bn funding shortfall, the Trustee agreed a 16 year recovery plan. The Trustee only felt able to take this risk and agree such a long term recovery plan because of its view at that time of BT plc's ongoing commitment to the Scheme and financial strength, including BT plc's expected long term and sustainable cash flow generation.

3.6 The Trustee and BT plc also entered into legally binding agreements to improve the security of the Scheme for the benefit of its members. These included protections around shareholder distributions, disposals and acquisitions and are referred to as the 2014 Funding Agreements in this submission.

3.7 Since the 2014 Valuation was concluded, market conditions have remained difficult, in particular with long term interest rates in the UK falling substantially. This has contributed to a deterioration in funding levels for the vast majority of UK defined benefit pension schemes. The Scheme has not been immune to this challenging environment. The actuarial report as at 30 June 2015 (prepared by the Scheme Actuary in lieu of a full actuarial valuation using assumptions consistent with the 2014 Valuation) showed a deficit in the Scheme of c.£10bn and, while the calculations for the funding update as at 30 June 2016 are still being finalised, [CONFIDENTIAL].

	2014 Valuation	2015 Interim actuarial valuation	[CONFIDENTIAL][8]
Market value of assets	£40.4bn	£43.1bn	[CONFIDENTIAL]
Technical Provisions	£47.4bn	£53.0bn	[CONFIDENTIAL]
Funding shortfall	£7.0bn	£10.0bn	[CONFIDENTIAL]

3.8 If a full actuarial valuation were to be carried out as at 30 June 2016 [CONFIDENTIAL]. The Trustee would, however, consider whether the 2014 Valuation assumptions remained appropriate in light of any changes in relevant factors since 2014. [CONFIDENTIAL

] the continued low interest rate environment and more challenging economic outlook are key factors that could negatively impact the size of any deficit.

3.9 The Pensions Regulator's code of practice on scheme funding notes that an estimate of "solvency" (usually, the cost of securing all liabilities in a pension scheme with an insurer on the open market) is a useful reference point when considering the adequacy of the scheme's Technical Provisions. The BTPS is too big to expect its liabilities to be taken on by an insurer, so in its case the solvency estimate is determined by the Scheme Actuary on the basis of a "self-insured" position assuming no further contributions from BT plc and no further accrual of benefits, and that a low risk, closely matched, investment strategy is adopted including additional margins for any unhedged risk. As at 30 June 2014, the solvency deficit on this basis was £23.6bn, some £16.6bn higher than the Technical Provisions shortfall at the same date and equivalent to a solvency level of 63%. Given the challenging market conditions since the date of the 2014 Valuation, this position has deteriorated [CONFIDENTIAL]. The deficit on a solvency basis can be seen as one measure of the extent of the BTPS's reliance on the Employer Covenant.

3.10 Given the potential impact the Ofcom Proposal could have on the Employer Covenant and the other challenges it could present to the Scheme, the Trustee has to ensure that

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[8] [CONFIDENTIAL].

it is in a position to protect the Scheme and seek additional funding from BT plc should outcomes of the Ofcom review warrant such actions (see also paragraph 7.5).

Current assessment of the Employer Covenant

3.11 Given the size of the Scheme relative to its sponsor, the funding position noted above, and the importance of a strong covenant to the long term security of the Scheme, the Trustee has monitored carefully the development of the Employer Covenant over time and has strived to balance protecting members' benefits with supporting BT plc in its efforts to secure the sustainable growth of its business. As noted above, the Trustee's view of the projected ongoing resilience or otherwise of the Employer Covenant is significant to the outcome of any valuation as it influences the level of prudence the Trustee would consider appropriate and the length of time the Trustee feels able to give BT plc to make good any shortfall.

3.12 To date, the Trustee has been willing to take a long term view in respect of the recovery of this deficit due to, among other reasons, the Trustee's view of the strength of the Employer Covenant and the flexibility which the BT Group has to manage and/or flex its business priorities, including capital expenditure and dividend policy, in order to meet its obligations to the Scheme. This long term view would need to be revisited in the event that the long term prospects for the Employer Covenant weakened and/or that flexibility was lost.

3.13 The Employer Covenant rests predominantly with BT plc although BT Fleet Limited, a subsidiary of BT plc, is also an employer. Save for the recent acquisition of EE, BT plc itself owns the vast majority of the BT Group's assets (including the BT Group's key tangible asset, the Openreach network) and generates the vast majority[9] of the BT Group's profits. [CONFIDENTIAL

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3.14 The size and stability of the cash generation of Openreach has been a particularly significant part of the Employer Covenant. It has been an important consideration in underpinning the level of investment risk assumed as part of the Scheme's long term investment strategy. As such, it has led to a lower level of Technical Provisions, and longer recovery periods, than would otherwise have been the case.

3.15 [CONFIDENTIAL

[9] For the year ended 31 March 2016, BT plc accounted for more than 80% of the overall group's net assets and profit before tax.

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3.16 BT plc's cash flow generation has improved significantly in recent years with Openreach making an important contribution, particularly in years in which other parts of the business have come under pressure.

3.17 Following the acquisition of EE by BT Group plc for a conservative mixture of debt and equity, BT agreed with the Trustee to hive down EE from BT Group plc (which is above BT plc and therefore outside the Employer Covenant) so that it would become a subsidiary of BT plc. In addition, further to the 2014 Funding Agreements, all of BT plc's subsidiaries, now including EE, are subject to a "negative pledge" that effectively restricts the amount of secured debt BT plc and its subsidiaries can issue. As a consequence, while the Trustee would have preferred not to be structurally subordinated to direct creditors of EE, the Trustee considers the acquisition of EE by BT plc to be additive to the Employer Covenant overall (and preferable to the alternative of EE being outside the Scheme's covenant group).

3.18 Since the conclusion of the 2014 Valuation, the Trustee has received regular reports from Penfida on the development of the Employer Covenant. Following the publication of the Ofcom Proposal, the Trustee commissioned Penfida to provide an updated covenant report assessing the current strength of the Employer Covenant and the potential impact of the Ofcom Proposal.

3.19 In summary, Penfida reported that the BT Group has experienced sustained growth in its underlying profitability, in large part due to cost transformation, assisted by the stable performance of Openreach and the acquisition of EE. Future profitable growth is expected across the majority of the BT Group's divisions, supported by ongoing cost transformation and synergies arising from the EE transaction, leading to increased cash flow generation. This improvement in underlying performance is reflected in the value Penfida places on the Employer Covenant, ranging from £[CONFIDENTIAL]bn-£[CONFIDENTIAL]bn, depending on the assumptions used.

3.20 The improvement in BT plc's underlying performance and the value of the Employer Covenant, has, however, to be set in the context of the substantial increase in scale of the BTPS pension deficit. [CONFIDENTIAL

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10 [CONFIDENTIAL].

3.21 [CONFIDENTIAL

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Current risk in the Scheme

3.22 In addition to negative changes in the Employer Covenant, the Scheme is exposed to five main risk factors, being:

(i) **Changes in long term UK interest rates**: The sensitivity of the Scheme's Technical Provisions to long term UK interest rates is currently that the liabilities increase by [CONFIDENTIAL] for every 0.01% decrease in interest rates. An additional challenge is that, due to convexity, sensitivity to a further fall in interest rates increases as interest rates fall;

(ii) **Changes in UK inflation**: The sensitivity of the Scheme's Technical Provisions to UK inflation is currently such that the liabilities increase by [CONFIDENTIAL] for every 0.01% increase in inflation;

(iii) **Changes in longevity**: We estimate that the Scheme's Technical Provisions currently increase by c.[CONFIDENTIAL] for every additional year of life expectancy at age 60;

(iv) **Asset risk**: Currently, some 60% of Scheme assets are invested in growth assets, including equities and property, with the remaining 40% invested in assets which have a more stable value relative to the liabilities. Reductions by a pension plan in its growth asset allocation typically increase the cash demands made on the sponsoring group (because it leads to reduced investment return expectations). However, growth assets are expected to have more variable value relative to liabilities, so a pension trustee's willingness to continue with a significant allocation to such assets is fundamentally linked to its level of confidence in the employer covenant; and

(v) **Liquidity and cash flow risk**: It is important to ensure that the Scheme's assets are adequate and sufficiently liquid such that it can meet all its cash and collateral payment obligations. These risks become more acute as a scheme matures. Having closed to new members in 2001, over 60% of the Scheme's membership is now retired and annual benefit outflows are expected to total £2.4bn in 2016.

Action taken to mitigate investment risk

3.23 Recognising these risks, the Trustee has already established objectives of reaching a 40% hedge ratio for interest rates and inflation by [CONFIDENTIAL] and to reduce the level of investment risk gradually over time, with the intention of moving to a substantially lower risk investment strategy by 2034 – objectives that were reflected in the 2014 Valuation. The Trustee has been engaged in a sustained programme to hedge the Scheme from fluctuations in interest rates, inflation and longevity. As a result the Scheme's hedge ratios in respect of interest rates and inflation have increased to [CONFIDENTIAL] and [CONFIDENTIAL] respectively (on a solvency type basis). In addition, in 2014 the Scheme entered into a £16bn longevity insurance transaction. [CONFIDENTIAL

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3.24 Furthermore, in 2009 BT introduced PIE (a pension increase exchange) which gave members the option at retirement to exchange a pension increasing in line with future inflation for a higher current pension payment. To date some 40% of eligible members have selected this option. More recently the option has been extended to current pensioners. The effect of this option, to the extent it is taken up, is to reduce the Scheme's sensitivity to changes in the level of inflation.

3.25 However, given the sheer size of the Scheme, it takes time to implement change and it is not realistic for the Scheme to fully hedge out its liabilities in the medium, let alone short, term. For example, the £16bn longevity insurance transaction took many months to carry out the necessary due diligence, negotiate terms and implement. It was the largest ever such transaction globally, but it provided a hedge for only approximately 25% of the Scheme's sensitivity to changes in longevity. Similarly, the Scheme's sensitivity to interest rates and inflation are large compared to available market liquidity; increasing the hedge ratios can only be achieved incrementally over time.

3.26 [CONFIDENTIAL

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3.27 Estimating the total amount of funding risk within a complex portfolio of asset and pension liabilities is challenging. In assessing the level of funding risk within the Scheme the Trustee considers a range of approaches, including long term historical analysis, recent Scheme experience and forward looking scenarios. For Scheme funding purposes the Trustee considers a balanced assessment of the current level of risk in the Scheme, measured by a 1 year 95% Value at Risk, is c.[CONFIDENTIAL]bn (after taking into account the current status of the mitigants in place). This means that there is a 5% probability that in any given year the Scheme's Technical Provisions funding deficit will increase by £[CONFIDENTIAL]bn.

3.28 In summary, even after taking into account the actions already instigated by the Trustee, there remains a material level of investment risk in the Scheme. To date, the Trustee has felt able to maintain this level of investment risk due to the strength of the Employer Covenant. This would need to be reviewed in the event of any material weakening of the Employer Covenant.

Summary of the Trustee's current position

3.29 The Trustee places material reliance on the Employer Covenant and, as Penfida's analysis indicates, the current funding position of the Scheme, while challenging, should, ignoring any impact of the Ofcom Proposal, be manageable from BT plc's perspective and can be afforded without prejudicing the sustainable growth of its business. However, despite the meaningful actions taken by the Trustee to reduce risk in the Scheme, the economic environment continues to be problematic, exacerbating the difficulties of managing a maturing scheme with increasing annual benefit payments. The Trustee would therefore be extremely concerned should the Employer Covenant be weakened.

4. ISSUES ARISING FROM THE OFCOM PROPOSAL

4.1 Prior to the acquisition of EE, the Trustee had direct recourse to the vast majority of the assets and cash flows of BT plc across each of its operating divisions, including Openreach, to fund any liabilities of the Scheme, ranking on an even footing with other creditors of BT plc. Now, the Scheme also has indirect access to the value within EE as a wholly-owned and controlled subsidiary of BT plc in addition to the assets and cash flows of BT plc. The Ofcom Proposal, however, would result in BT plc substituting direct ownership of the Openreach assets for shares in Openreach Co as a wholly-owned subsidiary; in contrast to the additive impact of the newly-acquired EE business, it would involve restructuring an integral and historic component of the Employer Covenant rather than bringing a new business into the BT Group.

4.2 The Ofcom Proposal therefore creates significant risks for the Scheme. We consider that there are seven key aspects of the Ofcom Proposal that have the potential to materially damage the strength of the Employer Covenant and/or to otherwise create increased risks for the Scheme and its members. These are:

(i) The **structural subordination** of the interests of the Scheme to the investment and business priorities of Openreach Co, including the loss of recourse to Openreach Co assets;

(ii) The potential for **alienation of cash flows**, including loss of recourse to cash flows and the creation of a separate Openreach Co treasury function;

(iii) The potential for long term **loss of value** to the BT Group;

(iv) The proposed **governance arrangements**, including how the proposed duties or decision-making processes of the Openreach Co board would interact with the Scheme's long term need to become and remain fully funded on an appropriate basis;

(v) **Movement of employees**, including the implications for c.17,000 Openreach employees if they cease to be eligible to accrue ongoing benefits in the BTPS;

(vi) The potential for an alteration in the scope and/or effectiveness of the **Crown Guarantee**; and

(vii) **Ongoing regulatory uncertainty**. The possibility of further regulatory intervention (regardless of the outcome to the present review) has the potential to reduce the Trustee's willingness to rely on the Employer Covenant in lieu of cash contributions, particularly as the Trustee is required to take a long term view of risk.

We address each issue below together with a summary of Penfida's assessment of the cumulative impact these issues could have on the Employer Covenant.

Structural subordination

4.3 Under the Ofcom Proposal, Openreach would become a distinct incorporated company. Ofcom has indicated that its starting position is that the assets already controlled by Openreach would be transferred to the new legal entity. The Ofcom Document states that the "*model seeks to limit the potential effects on the pension [scheme] by the fact that BT retains ultimate access, as the sole shareholder, to Openreach's activities, assets and cash flow*".[11]

4.4 However, this approach of itself would reduce the Employer Covenant strength because BT plc's access to Openreach Co's "activities, assets and cash flow" would be structurally subordinated to creditors at the Openreach Co level.

4.5 At present, the Scheme is an unsecured creditor of BT plc in respect of BT plc's funding obligations under the 2014 Funding Agreements and any ultimate shortfall in the Scheme's ability to make good benefit obligations to members. As such, the Scheme currently ranks alongside all other senior unsecured creditors of BT plc in having a claim against the assets of the Openreach business, as they are assets of BT plc. After the reorganisation contemplated in the Ofcom Proposal, the Scheme's ultimate access to the value of these assets would be subordinated to the recoveries of all creditors at the level of Openreach Co. Put simply, BT plc's recoveries as a shareholder in respect of Openreach Co on a winding up would rank behind those of all of Openreach Co's creditors.

4.6 The extent to which structural subordination of BTPS to creditors of Openreach Co would represent a new risk to the Scheme should not be underestimated. At present, BT plc holds the majority of the BT Group's operating assets, the only significant exception being those assets recently brought into the BT Group as part of the EE transaction which the Trustee considers overall to be additive to the Employer Covenant (see paragraph 3.17 above).

4.7 The extent to which this is damaging to the Employer Covenant would depend on:

(i) the value of the assets and cash flows transferred; and

(ii) the potential liabilities of Openreach Co.

4.8 We note that Ofcom itself has recognised that the Trustee's assessment of risk is a crucial factor, and "*some aspects of [Ofcom's] proposal, such as incorporation of Openreach and the transfer of assets and people, could increase the Trustees' assessment of these risks*".[12]

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[11] Paragraph 5.12 of the Ofcom Document.

[12] Paragraph 5.5 of the Ofcom Document.

Value of assets transferred

4.9 Ofcom's starting position in respect of assets is that Openreach Co should own the underlying infrastructure (such as underground ducts and telegraph poles) associated with the current Openreach network. Leaving aside the feasibility of distinguishing which assets should be allocated to Openreach and the practicalities of effecting such a transfer, the Trustee's view is that the transfer of the Openreach infrastructure assets and brand to Openreach Co has the potential to have a significant negative effect on the Employer Covenant because it would result in the structural subordination of the BTPS in relation to those assets.

4.10 We note that even if assets are not legally transferred to Openreach Co, the degree of control Openreach Co has over assets could nevertheless raise concerns if it would introduce new limitations and/or restrictions on BT plc's ability to sell, charge, transfer, dispose of or otherwise deal with assets in order to meet its obligations to the Scheme – as discussed in paragraphs 5.24 and 5.25.

4.11 Ofcom further proposes that Openreach Co "*would have its own treasury function (i.e. own bank accounts) for the management of cash and financial risks within the boundaries defined in the agreed financial envelope*".[13] It is not clear what the ramifications of such proposals would be and whether it is intended that Openreach Co would be able to "ring-fence" part or all of its working capital such that it would either not participate, or only participate to a limited or independently determined extent, in the wider BT Group's cash pooling and intra-group lending arrangements. If so, this could mean that BT plc would lose direct access to Openreach Co's cash as a source of funding for its liabilities to the Scheme.

Potential liabilities of Openreach Co

4.12 Given the structural subordination risk, the ability of Openreach Co to raise debt would have serious implications. Ofcom states that it does not envisage Openreach Co raising its own debt under the Ofcom Proposal.[14] The Trustee is, however, concerned that this position could easily change in the future once Openreach Co becomes a separate legal entity. In particular, it is not clear whether Ofcom intends that Openreach Co would be formally restricted (e.g. by its articles of association, or by direct covenant in favour of the Trustee) from raising third party debt, or whether it is simply assumed Openreach Co would not raise debt in practice. It is also not clear whether any restriction on Openreach Co borrowing on its own account would extend to Openreach Co guaranteeing BT plc's debt. Even if Openreach Co does not itself become a borrower, it is likely that other creditors of BT plc will have similar concerns to the Trustee in respect of the effect of the creation of Openreach Co on BT plc's creditworthiness, and will look for Openreach Co to become a guarantor of BT plc under its main bank and bond financings in future (and in some instances in the present; for example, the terms of BT plc's bonds due 2025 and 2028 could be read as requiring such a guarantee to be granted as a condition of any transfer of a substantial part of BT plc's business to a subsidiary). This would be a

[13] Paragraph 4.52 of the Ofcom Document.

[14] See paragraph 5.46 of the Ofcom Document.

difficult request for BT plc to resist and not doing so might have implications for BT's own cost of funds. If such arrangements were put in place, the interests of BT plc's (guaranteed) banks and bondholders would effectively rank ahead of the interests of the Scheme (as obligations of Openreach Co as guarantor would be paid before Openreach Co's assets would be passed to BT plc on an insolvency).

4.13 Unless Openreach Co is fully prohibited from raising or guaranteeing debt in the future, the Trustee would, when considering the right level of risk for the Scheme's long term valuation assumptions and how much risk to accept when setting the recovery period of any funding shortfall, need to consider the medium term possibility of Openreach Co creating debt or contingent liabilities in respect of debt arising at the Openreach Co level.[15] Even if the restriction on creating or guaranteeing debt were formalised, we would have concerns about the permanence and enforceability of this restriction. The Trustee can only take a long term view of funding on the basis of a long term view of risk, and it seems hard to rule out the possibility under the Ofcom Proposal that Openreach Co may raise debt in the future. Given the scale of the Scheme's liabilities (and therefore the difficulty of seeking immediate recovery of additional amounts required in response to changes in the Employer Covenant), this is not a prospect which the Trustee can just ignore for present purposes. It is neither credible nor appropriate to assume that future changes in the Employer Covenant can be dealt with as and when they occur if the only satisfactory way of dealing with those changes may be to require cash transfers from the BT Group businesses to the Scheme of several billion pounds.

4.14 The Trustee is also concerned about the legally separate Openreach Co taking on other third party exposures. Debt finance is only one type of potential creditor liability, and there is scope for Openreach Co to take on significant third party exposures without raising or guaranteeing debt finance. For example, Ofcom envisages that Openreach Co would enter into co-investment projects with its customers. It is hard to see how this would not involve the earmarking of Openreach Co revenue streams and competing securities / guarantees at the Openreach Co level.

Alienation of cash flows

4.15 The Ofcom Proposal contemplates that Openreach Co would have "*greater independent control over its strategy, operation and allocation of the agreed finances*".[16] The Ofcom Proposal suggests that this would be achieved by Openreach Co and BT plc agreeing (in advance) targets and limits for a number of financial years, covering key financial metrics such as revenue, operating costs, capital expenditure and cash flow. This is described as a "financial envelope". Ofcom further states that "*[within] this envelope, [Openreach Co] would have delegated authority to develop and manage its own strategic and annual operating plans. [Openreach Co] would also be able to make recommendations to the BT Group Board for increased spending*."[17]

[15] Unless the restrictive covenant was given in favour of the Trustee.

[16] Paragraph 4.40 of the Ofcom Document.

[17] Paragraph 1.24 of the Ofcom Document.

4.16 The Ofcom Proposal does not specify how Scheme obligations would be factored into the preparation of the financial envelope by the BT Group or into subsequent decisions by the Openreach Board.

4.17 A key feature of the financial envelope is that Openreach Co would have its own treasury function and bank accounts and, as is noted at paragraph 4.11 above, it is not clear whether this means Openreach Co's cash can/must be kept separate from that of the remainder of the BT Group. This gives rise to three concerns:

(i) there appears to be no mechanism by which BT plc could intervene in respect of decisions taken within the financial envelope, should this be required in order for the BT Group to meet its ongoing obligations to the Scheme;

(ii) there could be constraints on the upstreaming of cash from Openreach Co to BT plc; and

(iii) the long term nature of network investments could mean that capital expenditure decisions taken within the financial envelope without BT Group approval may, in practice, "lock-in" the BT Group's support for these capital projects over a period of several years to completion, (notwithstanding the aspect of the Ofcom Proposal that suggests the BT Group Board would approve the Openreach Co budget on an annual basis).

Inability to amend financial envelope in order to meet obligations to the Scheme

4.18 Once the financial envelope has been set, it appears that there would be limited scope for BT plc to gain access to those funds. We note that the Ofcom Document does refer to "*exceptional circumstances where BT Group would need to step in and retain oversight over specific aspects of [Openreach Co's] activities*".[18] Such circumstances are cited as including "*major underperformance by the Openreach Board that exposes BT Group to significant risks*" and to "*extreme performance issues outside of [Openreach Co], for example the failure of a BT Group division, that challenge BT Group's overall financial viability*".[19] The Ofcom Document notes that "*such circumstances have been rare since BT was privatised*"[20] and Ofcom would expect to prescribe a defined list of circumstances in which the BT Group could access funds placed within the financial envelope.

4.19 There is nothing in the Ofcom Document to suggest that the BT Group could, under the Ofcom Proposal, alter the financial envelope or retrieve funds included within the financial envelope, in order to meet its obligations to the Scheme. The Openreach business currently accounts for one third of BT Group operating free cash flow, and the "utility-like" nature of the Openreach revenues means the Trustee considers them to be the most

[18] Paragraph 4.65 of the Ofcom Document.

[19] Paragraph 4.66 of the Ofcom Document.

[20] Paragraph 4.66 of the Ofcom Document.

consistent and reliable portion of BT plc's overall income when assessing the Employer Covenant. Consequently, this is a material concern for the Trustee.

Constraints on the upstreaming of cash

4.20 In addition to concerns about the lack of the BT Group's ability to control or recall funds placed within the financial envelope in order to meet obligations to the Scheme, the Trustee has concerns about how cash generated by the business and investments that are subject to the financial envelope will be upstreamed to BT plc, which is not explained in the Ofcom Document.[21]

4.21 As described above, the Ofcom Proposal causes the Trustee significant structural subordination concerns in the context of an insolvency and winding up of BT plc and/or Openreach Co. In addition, the Trustee is concerned that the Ofcom Proposal may impact the ability of BT plc to afford the ongoing contributions needed to restore the Scheme's funding position; to finance continued accrual; and to pay for other costs that are financed by the Sponsoring Employer such as administration costs and the Pension Protection Fund levy. In particular, the Ofcom Proposal involves the removal from BT plc of the cash flows arising from contracts with the customers of the Openreach Co business.

4.22 As a result, cash that is currently available to BT plc to meet its funding obligations in respect of the Scheme would, under the Ofcom Proposal, be "locked up" in Openreach Co. This would apply not only to receivables under external customer contracts with third party customers, but also to the internally accounted payments made by BT plc's retail businesses to Openreach Co for the use of Openreach Co's network. At present, these cash flows are accounted as being attributable to Openreach, but remain available to BT plc for making payments to the Scheme and other creditors. As noted in paragraph 1.6, the Openreach revenues are particularly important to the Employer Covenant given their stability and reliability.

4.23 We anticipate that BT plc, as the sole shareholder, would have a legitimate expectation that it would receive dividends from Openreach Co and that cash would therefore be upstreamed to BT plc via this route. However, relying on upstreaming cash by way of dividends raises a number of issues:

(i) from a practical perspective, dividends can only be paid if sufficient distributable reserves are available. Such reserves are created effectively in arrears once profits for an accounting period have been determined using the appropriate accounting basis. It is quite usual for there to be material divergences between profits for accounting purposes and a company's actual cash flow generation. In certifying a

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[21] The Ofcom Proposal does not specify how the Openreach assets would be transferred from BT plc to Openreach Co. More particularly, it is not clear how Openreach Co would be funded so as to enable it to pay the purchase price for those assets; would Ofcom require BT plc to capitalise Openreach Co sufficiently such that Openreach Co was able to pay the purchase price in cash or could the purchase price be left outstanding as an inter-company debt owing to BT plc? These details, which will have an important impact both on the mechanics of moving cash between Openreach Co and BT plc and on Openreach Co's ability to take on direct liabilities to the Scheme as considered below, constitute an additional source of uncertainty for the Trustee in assessing the Ofcom Proposal.

company's accounts, the auditors would take into account any dividend proposals, verifying the existence of appropriate distributable reserves and the impact of such payments on the company's ability to continue to operate as a going concern;

(ii) typically, the appropriateness and level of dividends that a company pays to its shareholders is determined in the first instance by the board of directors. In recommending the payment of a dividend to its shareholders, the board have to take into account the financial position of the company and the affordability of any proposed dividend. Factors that would influence the board would include the solvency of the company, ongoing business priorities, and any anticipated accounting matters that could affect distributable reserves subsequently, etc. In the case of Openreach Co, we assume the Openreach Board would also have to have regard to the company's Customer Purpose (see paragraph 4.30); and

(iii) given the independent nature of the Openreach Board and that it would be empowered to take decisions that are not influenced by the wider interests of the BT Group, we envisage that the Openreach Board will not necessarily look to pay the maximum dividend possible to BT plc.

4.24 It is also not clear at present to what extent Openreach Co would have a right to retain and deploy its own cash reserves in capital expenditure, whether within or outside the scope of the agreed budget envelope.

4.25 Again, the Trustee's ability to take a long term view on funding through peaks and troughs of the business cycle depends on it being clear that those peaks and troughs will not affect its access to the cash flow and assets which make up its Employer Covenant. Any loss of access to, and control over, group cash by BT plc has the potential to impair the strength of the Employer Covenant.

Lock-in of investment support

4.26 As noted above, the Ofcom Proposal states that "*BT Group would set a 'financial envelope' (a set spending capacity). Within this envelope, Openreach would have delegated authority to develop and manage its own strategic and annual operating plans. Openreach would also be able to make recommendations to the BT Group Board for increased spending*."[22] The Ofcom Proposal then further states, in respect of investments falling outside the financial envelope, that "*BT Group would need to have visibility of major investment or operational decisions that could have a material bearing on BT Group finances. It would also need to be able to decide whether or not to proceed with these*."[23]

4.27 The Trustee's concern is that Openreach Co could make very significant strategic investment decisions that technically fall within the financial envelope, but in practice commit the BT Group and/or Openreach Co to a particular strategy or long term investment. We understand that the nature of telecommunications investments are such that many investment projects can be approached in stages (thus seemingly falling within

[22] Paragraphs 1.24 and 4.11.6 of the Ofcom Document.

[23] Paragraph 4.54 of the Ofcom Document.

a certain cost bracket), but the full value of the investment may not be achieved without network scale. In some cases, it may be that there would be no real prospect of the BT Group turning back once the initial investment had been committed by Openreach Co. The Trustee would be concerned if major strategic decisions were made that could affect BT plc, and consequently its ability to stand behind the Scheme, without full oversight of the BT Group Board.

Potential loss of value

4.28 The Ofcom Proposal has the potential to diminish the value of the BT Group, which would, of course, affect the strength of the Employer Covenant. While the Trustee is not best placed to identify (or quantify) all of the impacts of the Ofcom Proposal on the value of the BT Group, we believe these would include:

(i) significant one-off costs to the BT Group in implementing the Ofcom Proposal;

(ii) reductions in efficiencies. Under the Ofcom Proposal, the new Openreach Co "*would have greater resources, giving it the technical and commercial capability to develop strategy and manage its operational delivery without relying on BT Group*".[24] What this is likely to require in practice is the division and replication of business, HR and technical functions and support currently provided on an integrated basis across the BT Group. This could be expected to reduce synergies and economies of scale in the BT Group, increasing the costs of business;

(iii) scope for Openreach Co's business lines to be brought into direct competition with other BT Group businesses. In particular, the co-investment models with third parties envisaged by the Ofcom Proposal could lead to this outcome; and

(iv) implications for BT plc's cost of funds for the reasons set out in paragraph 4.12.

4.29 The financial health of the BT Group directly affects the strength of the Employer Covenant upon which the Trustee relies. Therefore, the Trustee is concerned with the potential long term effects of the Ofcom Proposal on overall group profitability and cash flow.

Governance arrangements

Openreach decision-making

4.30 To ensure that Openreach Co acts in the interests of all customers equally and does not favour the interests of the BT Group, Ofcom believes that the articles of association of Openreach Co should "*make clear that the company's core purposes include acting in the interests of all customers equally*"[25] (the "**Customer Purpose**"). The articles of association would additionally require the Openreach Co directors to "*ensure that*

[24] Paragraph 1.24 of the Ofcom Document.

[25] Paragraph 4.30 of the Ofcom Document.

Openreach complied with its regulatory obligations"[26] (the "**Regulatory Purpose**").[27] Based on paragraphs 4.30 and 4.32 of the Ofcom Proposal, we understand that Openreach Co's directors would also have a duty to promote the success of Openreach Co for the benefit of its shareholder (the "**Shareholder Benefit Purpose**").

4.31 The Trustee has significant concerns that this proposed multi-limbed corporate purpose could have material consequences for how the obligations of the BT Group to the Scheme are factored into decisions relating to the Openreach business.

4.32 Under the status quo, the BT plc directors, when considering a proposal relating to Openreach, are required to act in a manner which promotes the success of BT plc for the benefit of its shareholder (i.e. the Shareholder Benefit Purpose). When deciding whether the approval or rejection of that proposal would be more likely to achieve the Shareholder Benefit Purpose, the BT plc directors would be expected to have regard to a number of matters, including (in light of their significance to BT plc's financial position) BT plc's obligations to the Scheme. In particular, if a material investment in Openreach was proposed, the Trustee would expect the directors to consider (among other things) whether or not such an investment would hinder the company's ability to satisfy the Scheme's funding requirements.

4.33 In contrast, the Openreach Board would, when faced with an identical decision about the Openreach business, need to have regard to each of the Customer Purpose, the Regulatory Purpose and the Shareholder Benefit Purpose. There could be many circumstances where the Customer Purpose and the Regulatory Purpose conflict with the Shareholder Benefit Purpose – for example, where the Openreach Board must decide whether to direct its cash resources to a project to roll-out new broadband infrastructure (which would be consistent with the Customer Purpose and, possibly, also with the Regulatory Purpose) or to advance that cash to BT plc to allow it to satisfy its pensions obligations. As actions by Openreach Co to satisfy the BT Group's pensions obligations are unlikely to be consistent with the Customer Purpose or the Regulatory Purpose, the Trustee believes the Ofcom Proposal will necessarily result in the relevant Openreach decision-makers having less regard to Scheme-related obligations than at present. It is difficult to see how this would not have a negative impact on the Employer Covenant.

4.34 Even if Ofcom did not proceed with the proposed multi-limbed corporate purpose for Openreach Co, we would still have residual concerns about the impact on the Scheme of the governance features of the Ofcom Proposal. In particular, for so long as it is BT plc (and not Openreach Co) which is primarily responsible for funding the Scheme, those funding obligations are likely to be less critical to Openreach-related decisions taken by the Openreach Board than they are when taken by the BT plc board today.

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[26] Paragraph 4.32 of the Ofcom Document.

[27] In proposing these purposes, Ofcom notes that "*under s. 172 of the Companies Act 2006 where a company's purposes consist of or include purposes other than for the benefit of its members, the directors must act in the way they consider, in good faith, would be most likely to achieve those purpose*".

Visibility of Openreach business decisions

4.35 As part of the agreement of the 2014 Valuation and 2014 recovery plan, BT plc and the Trustee entered into agreements (the "**2014 Funding Agreements**") that provided the Trustee with, among other things, certain information and consultation rights in respect of significant corporate events. [CONFIDENTIAL] the value of these undertakings to the Scheme (and more particularly the Trustee's visibility of the Openreach business) may be reduced.

4.36 At present, BT plc has significant flexibility in how it chooses to stand behind its obligations to the Scheme. The Trustee has been able to take account of BT plc's flexible treasury management and its ability to adjust its business plans, including those relating to capital expenditure and the payment of dividends, when assessing the strength of the Employer Covenant and affordability of pensions obligations.

4.37 The Ofcom Proposal envisages that Openreach Co would enter into confidential discussions with customers in respect of investment, without information being disclosed to the rest of the BT Group. This could make it difficult for the BT Group to have reasonable warning of significant proposed expenditure. This would in turn decrease the visibility of the Openreach business's expenditure commitments from the Trustee's perspective and could mean that the Trustee is unable to continue to place the same reliance on the BT Group having flexibility in areas such as capital expenditure.

Movement of employees

4.38 The Ofcom Proposal expresses a preference "*that people who work for Openreach would be employees of the new company, rather than employees of BT Group. This would prevent any real or perceived conflict of interest, and allow Openreach to develop its own distinct organisational culture*".[28] We note the advice taken by Ofcom that "*future liabilities (for example, payments to fill a funding gap) of a legally separate Openreach to the BTPS would not automatically be covered by the Crown Guarantee*".[29] We note that the movement of such employees is expressed as Ofcom's "*strong preference*",[30] and this is therefore another major concern which the Trustee has with the Ofcom Proposal.

4.39 We would flag in the first instance that an individual's eligibility to be an active member and to continue to accrue benefits in the BTPS is predicated on them being an employee of BT plc. If individuals leave service with BT plc and become employees of Openreach Co then they will automatically leave and become deferred members of the Scheme. Given that c.17,000 active members would be affected, this would be a major concern for the Trustee because those members might no longer accrue benefits.

4.40 The simplest solution to this issue would be for the Trustee to consent to Openreach Co becoming a participating employer in the BTPS such that its employees can continue to

[28] Paragraph 1.24 of the Ofcom Document.

[29] Paragraph 5.25 of the Ofcom Document.

[30] Paragraphs 1.24, 4.11.7 and 4.71 of the Ofcom Document.

be active members of the Scheme. However, in the context of the BTPS, any such step would result in material difficulties for the Trustee as any liabilities Openreach Co would then have to the Scheme (for example to fund ongoing accrual for its employees) would not be covered by the Crown Guarantee.

4.41 As explained at paragraphs 2.9-2.12 above, the Crown Guarantee applies to BT plc's obligations to the Scheme and any monies paid under it would serve to increase the total assets of the Scheme out of which all members' benefits would be paid. To the extent that obligations to fund the Scheme are taken outside the scope of the Crown Guarantee, it serves to "dilute" its effectiveness to the detriment of all members. Consequently, it is difficult to see how the Trustee could consent to the introduction of Openreach Co as a participating employer in the Scheme given the potential impact on the Crown Guarantee. The Crown Guarantee, although not taken into account in assessing the funding position of the Scheme from time to time, is a form of protection for Scheme members which cannot be effectively replicated through any private sector means. Maintaining its full scope, effectiveness and applicability is therefore of critical importance to the Trustee and to all Scheme members who work, or may in the future work, in Openreach.

4.42 In addition to the pensions issues noted above, the transfer of a material number of employees is likely to give rise to significant labour and industrial relations challenges that could adversely affect the strength of the Employer Covenant.

Crown Guarantee

4.43 In addition to the points raised above regarding the potential impact of enabling any employees of Openreach Co to accrue benefits in the BTPS, the Trustee has concerns that other aspects of the Ofcom Proposal could be prejudicial to the scope and effectiveness of the Crown Guarantee.

4.44 [CONFIDENTIAL]. We note the Ofcom Proposal includes suggestions that mitigants could be provided to the Trustee for any deterioration in the Scheme's position that might result. However, as is described in more detail at paragraph 5.38 below, we are extremely concerned by the process it is suggested would be followed whereby the incorporation of Openreach would be mandated and the Trustee left to resolve the issue of mitigation with BT/Government separately. This would give rise to a situation in which the Employer Covenant would have deteriorated and/or the position of the Scheme and Scheme members as regards the Crown Guarantee would have changed; the Scheme and Scheme members would be exposed to increased risk for a sustained period of time; and the Trustee would have no certainty that a satisfactory solution would and/or could be found.

4.45 [CONFIDENTIAL

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Ongoing regulatory uncertainty

4.46 Ofcom proposes to measure the success of the legal separation model by publishing monitoring reports initially every six months, and then annually. If the monitoring reports suggest the model is not delivering Ofcom's desired objectives, Ofcom envisages that it would undertake a more detailed review, and potentially require full structural separation. Ofcom notes at several points in the Ofcom Proposal that if its "*preferred model of legal separation cannot be made to work, then full structural separation remains an option*".[31]

4.47 This means that the Trustee could feasibly find itself addressing these issues again in a few years' time in submissions to Ofcom in the context of a further review or the Competition and Markets Authority in the context of a market investigation. The reporting proposed is frequent and apparently would continue perpetually (or until such a time as Ofcom imposed structural separation). Furthermore, the Ofcom Proposal provides little detail as to the criteria on which successful delivery would be assessed and, as acknowledged by Ofcom, some of its desired outcomes are not "*solely under the control of Openreach*".[32]

4.48 This uncertainty will likely result in significant increased costs. As discussed above, material changes to the structure of the BT Group could have a significant impact on the risks and costs associated with the Scheme. Similarly, ongoing regulatory uncertainty as to potential changes to the structure of Openreach (or Openreach Co) also introduces risk and cost. As explained at paragraph 3.5 above, the Trustee agreed that the deficit revealed by the 2014 Valuation could be recovered from BT plc over the period to 2030. The estimated deficit from the 2016 interim valuation [CONFIDENTIAL] is expected to be recovered from BT plc, if sustained, from the next valuation but the Trustee would need to consider not just the quantum but the timing and duration of such payments. The immediate burdens placed on BT plc will likely be significantly increased if the Trustee is not fully confident that it has an Employer Covenant which is undiminished from the present position and which will remain so in the long term. The increased regulatory uncertainty as a consequence of the Ofcom Proposal poses a threat to the Trustee's ability to take a long term view. If this position remains it will require the Trustee to consider carefully the timing and duration of any recovery plan.

Potential impact on the Employer Covenant

4.49 As noted previously, following the publication of the Ofcom Proposal, the Trustee commissioned a report from Penfida on the current covenant of BT plc and the impact that the Ofcom Proposal could have on the Employer Covenant.

4.50 Penfida have taken into account the current funding and risk position of the Scheme and the issues highlighted in this section. They have estimated that the Ofcom Proposal would, if implemented, reduce their valuation of the Employer Covenant by c.£[CONFIDENTIAL]bn. This is based on the assumed reduction in BT plc's cash flows

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[31] Paragraph 1.20 of the Ofcom Document.

[32] Paragraphs 1.47 and 6.3 of the Ofcom Document.

attributable to the initial one-off costs and the ongoing dis-synergies arising from the incorporation of Openreach; the likely increase in BT plc's weighted average cost of capital reflecting greater uncertainty over future cash flows due to the potential structural subordination of creditors and increased regulation; and a possible reduction in BT plc's ability to access the cash flows of Openreach, due to changes in Openreach's distribution strategy (including trapped cash).

4.51 The consequential reduction in the strength of the Employer Covenant would reduce BT plc's relative ability to support the Scheme. [CONFIDENTIAL

] the reduction in annual cash flows available to support payments to the Scheme would be of material concern given the increased funding which would be sought and the potential strain this could place on BT plc. Subject to the scale and timing of such funding requirements, this could result in an increase in BT Group debt levels and a reduction in BT plc's credit rating, increasing BT plc's cost of capital.

4.52 In addition, the Ofcom Proposal introduces further qualitative risks, including the potential risk of structural separation at a later stage and the potential for conflicts of interest between customers' needs and those of the Scheme. These effects may further negatively impact cash flow availability, and BT plc's access to capital, with perceived lower credit quality leading to higher interest costs and increased equity risk leading to a higher equity risk premium.

4.53 In summary, Penfida have concluded that the Ofcom Proposal would have multiple adverse implications for the quantum and quality of the covenant supporting the Scheme.

The BT Proposal

4.54 We note that Ofcom's view in respect of the BT Proposal is that "*whilst there are several areas of common ground between [the Ofcom] proposal and BT's plans, there are a number of areas where BT has not gone far enough and which, if unchanged, will not in [Ofcom's view] achieve the goal of a more independent Openreach on strategic and operational issues*".[34]

[33] [CONFIDENTIAL].

[34] Paragraph 9.7 of the Ofcom Document.

4.55 Should a compromise be reached between Ofcom and the BT Group that seeks to capitalise on the common ground and combines features from each proposal, the Trustee may still have a number of the concerns highlighted above.

Summary of issues arising from the Ofcom Proposal

4.56 As set out above, the Ofcom Proposal raises issues in respect of structural subordination, alienation of cash flows, potential loss of value, governance arrangements, cessation of future accrual for active members of the Scheme employed by Openreach, prejudice to the scope and effectiveness of the Crown Guarantee, and ongoing regulatory uncertainty.

4.57 The Trustee considers that as a result of these issues, the Ofcom Proposal would, absent any mitigation, potentially result in a material detriment to the Employer Covenant.

4.58 Other things being equal, this would necessitate the Trustee taking a more cautious approach in assessing the risks facing the Scheme. Ultimately, the Trustee would be likely to request increased payments from BT plc as part of its ongoing obligations to the Scheme. This financial burden would in turn affect the ability of BT plc to invest in its business, including the Openreach business, in the manner which we assume Ofcom would intend the Ofcom Proposal to promote.

4.59 The Trustee has also considered to what extent mitigants might be available to address its concerns and the next section of our response sets out our current conclusions in that regard.

5. MITIGANTS / ALTERNATIVE APPROACHES

5.1 The Ofcom Document notes some potential mitigants to address the various risks identified above and suggests that through some combination of these measures it may be possible to arrive at a position where the Ofcom Proposal is neutral for the Employer Covenant and for the risks facing the Scheme, Scheme pensioners and contingent and prospective pensioners. Ofcom notes that it is ultimately for the Trustee, taking a cautious approach, to determine what changes are able to be made to arrangements with the Scheme, and whether and to what extent each of the mitigants assists. We note that the Scheme Actuary will also have an important role in assessing the effects of changes as a result of the Ofcom Proposal in light of his specific function in setting the required employer contributions.

5.2 We have scrutinised the mitigants suggested by Ofcom to see how far it is realistically possible, in the specific circumstances of the Scheme, to arrive at a "risk-neutral" outcome for the Scheme and Scheme members. We have also considered with our advisors some additional alternative approaches. In particular, we have considered the scope to rely upon:

(i) A **guarantee**, **security over assets** and/or a **negative pledge**;

(ii) An **obligation on Openreach Co to upstream cash** to BT plc

(iii) A covenant in favour of the Trustee making Openreach Co **jointly and severally liable** for all obligations of BT plc with respect to the Scheme;

(iv) An **access agreement dealing with assets**, while allowing a degree of control to be given to the Openreach Board;

(v) **Step-in rights** for BT plc with respect to Openreach Co;

(vi) Amendments to the **Openreach Co governance arrangements** to require consideration of Scheme issues;

(vii) A **service agreement dealing with employees**;

(viii) Extension of the **Crown Guarantee**;

(ix) A **non-compete provision**;

(x) **Extension of the protections contained in the 2014 Funding Agreements**; and/or

(xi) **Increased cash contributions** to the Scheme.

We address these potential mitigants and alternative approaches below.

Guarantees, security and a negative pledge

5.3 Ofcom proposes three conventional credit support concepts as potential mitigants to the risks raised by the Ofcom Proposal. These are a guarantee, security over assets and a negative pledge. These are distinct, but related, concepts:

(i) a guarantee could be put in place to make Openreach Co jointly and severally liable for all of BT plc's obligations towards the Scheme, on a continuing basis and not just on an insolvency. Any such guarantee would be expected to have additional features and protections, such as guaranteed equal ranking with all other unsecured and unsubordinated creditors. This would help to address structural subordination to some extent, as it would allow for the Scheme to become a creditor of Openreach Co as well as a creditor of BT plc on an insolvency and allow the Trustee to have recourse against Openreach Co in respect of a payment obligation to the Scheme which BT plc has failed to honour;

(ii) security over the assets of BT plc transferred to Openreach Co would support this guarantee obligation by promoting the priority of the Scheme's claim against Openreach Co from that of an unsecured to a secured creditor on an event of default or on an insolvency; and

(iii) Ofcom also proposes that a negative pledge be given by Openreach Co.[35] A negative pledge would traditionally be an undertaking by a party not to create security over any of its assets, subject to limited carve outs. The Trustee already has such arrangements in place with respect to BT plc and the BT Group and would expect it to continue to encompass any new subsidiaries including Openreach, should it be established.[36] A negative pledge (including limitations on third party indebtedness) at the level of Openreach Co would provide comfort to the Trustee that Openreach Co could not create security over its assets which would rank ahead of those of the Trustee against Openreach Co on an event of a default or on an insolvency of Openreach Co, and that third party borrowings would be limited.

Guarantees

5.4 A guarantee is a contingent obligation – it requires the primary obligation (in this case BT plc's obligations to the Scheme) to have been called and not honoured before it can itself be called. We would expect any guarantee to be accompanied by an indemnity to create a primary obligation from Openreach Co to the Scheme as is standard in financing transactions under English law, but again the indemnity would only be called upon in the event of the Scheme having suffered a loss in respect of BT plc's obligations to the Scheme. By the time the Scheme was able to make a call under such a guarantee therefore, it would already be short of cash funding. The effect of a guarantee cannot

[35] Although what is envisaged in the Ofcom Proposal is a mix of negative and positive undertakings. The positive undertakings element of the Ofcom Proposal is dealt with in paragraphs 5.14-5.18 (Obligation to upstream cash) below.

[36] The 2014 Funding Agreements prohibit any member of the BT Group from securing financial indebtedness (save within specific carve outs or in an amount not exceeding £1.5bn) without providing equivalent security to the Scheme for BT plc's obligations to the Trustee under the 2014 Funding Agreements.

therefore restore the Trustee to its current position with respect to its direct access to the cash flows of Openreach as an integrated part of BT plc.[37]

5.5 In shaping any such guarantee, the Trustee would require absolute assurance that its legal effect and/or practical application would not cause any obligations of BT plc to the Scheme to be removed from the scope of the Crown Guarantee (or provide Government with the opportunity to assert that this has occurred). The Trustee would need to consider whether it would be necessary to confirm with Government the interaction of any guarantee (and any other relevant mitigation) with the Crown Guarantee before such mitigation could be accepted. This could, in and of itself, be of concern to the Trustee (see paragraph 5.38 below).

5.6 Looking to the long term, it is hard to imagine a situation where the Trustee would release an Openreach Co guarantee without requiring a very large immediate cash payment to the Scheme. This could act as an effective prohibition on any future sale or structural separation of Openreach Co. This is equally true of a direct payment obligation, considered below. Any such guarantee would certainly have to contain prohibitions on disposals or transfers of assets by Openreach Co to prevent any diminution in the value of the guarantee over time, and potentially other contractual restrictions and protections designed to maintain the covenant strength of Openreach Co. The putting in place of this mitigant would therefore limit Openreach Co's operational flexibility and store up complexity and potential issues for the future.

5.7 The granting of a guarantee by Openreach Co to the Trustee will doubtless encourage other lenders and bondholders to request the same. Failing to provide this would alter the perceived credit risk on debt at the BT plc level and increase cost of funds accordingly. Providing it would bring in other creditors alongside the Trustee and exacerbate structural subordination concerns. In summary, a guarantee cannot restore the Trustee's position and would likely introduce significant complexity and operational restriction to the Openreach Co arrangements, together with potentially material challenges regarding the Crown Guarantee.

Security

5.8 The Ofcom Document indicates that securing Openreach's assets to support the guarantee would lead to the obligations to the Scheme being preferred over any other creditor of Openreach on an insolvency. The Trustee does not agree that this would universally be the case; the Trustee in this scenario would look to obtain fixed and floating charges over assets, and while the only claims ranking ahead of a fixed charge holder would be the costs of realising the secured assets, there are still certain claims in an insolvency that would be mandatorily preferred over that of the floating charge holder.

5.9 This is not to downplay the attractiveness of security to the Trustee as a mitigant; if all other things remained equal and no other creditors shared in the security granted by

[37] We have asked our advisors to consider how Openreach Co might be made primarily and independently liable to the Scheme in respect of ongoing funding contributions. A preliminary view is that achieving this may require Openreach to directly assume part of the scheme liabilities, which would represent a more fundamental restructuring and exacerbate many of the risks and uncertainties we have identified.

Openreach Co to the Scheme, the Trustee agrees that it might have a better prospect of recovery on an insolvency of the BT plc / Openreach Co businesses as a creditor of Openreach Co with a significant security package than it would as an unsecured creditor of BT plc under the current arrangements for Openreach. However, we query whether BT plc would in fact be able, under the terms of its existing debt documentation, to grant such a security package. Separately, the Trustee has concerns about the knock-on impact that such a security package, even if obtainable, would have on the longer term prospects for the business of the BT Group (and thereby the broader Employer Covenant). In other words, it is hard to see how all other things would remain equal in this scenario:

(i) The terms of BT plc's bond documentation contain restrictions on BT plc transferring significant assets into a subsidiary either at all or without that subsidiary guaranteeing the bonds. [CONFIDENTIAL

]. Lenders to BT plc will have similar credit concerns as the Trustee would have with respect to the subordination of their claims to those of a prior ranking creditor (which the Trustee would become if it were to be granted a substantial security package). To be of real use to the Trustee as credit support, any security package would have to be sufficiently comprehensive to facilitate the disposal of the Openreach business (or Openreach Co itself) on a "going concern" basis in the event of BT plc's default or insolvency. Securing assets piecemeal would be unlikely to allow a simple enforcement or full realisation of value, as assets would be subject to a break up discount.

(ii) Even if BT plc were able to grant a comprehensive security package, it might then find itself unable to raise finance on competitive terms in the future if a substantial portion of the BT Group's assets and cash flows (as Openreach Co would certainly represent) were effectively ring-fenced to the Trustee as a secured creditor.

5.10 While a substantial security package is therefore attractive taken in isolation, we question whether and to what extent it is deliverable in practice without doing potentially significant damage to the business of the BT Group and thus exacerbating the deterioration of the Employer Covenant for which it is intended to compensate.

Negative pledge and indebtedness restrictions

5.11 The Trustee does not take comfort from the fact that Openreach Co is not intended to raise debt independently (thus, in theory, limiting creditor claims in an insolvency). As discussed at paragraph 4.12 above, it seems unlikely that any restriction on Openreach Co's ability to raise debt would be formalised and, if it were, such a restriction may not be sustainable. There is no mention in the Ofcom Document of any restriction on Openreach Co's ability to guarantee third party indebtedness, and we would anticipate that such guarantees would be required by BT plc's lenders. Ofcom's objective is to achieve operational independence for Openreach Co, for example, by undertaking co-investment projects with customers of its own determination. The Trustee would therefore expect that over time Openreach Co would increasingly take on substantive liabilities to third parties, possibly also involving securing assets to third parties. It is, for example, difficult to envisage co-investment projects in which both parties do not have some kind of proprietary interest in the resulting investment (including physical infrastructure).

5.12 A negative pledge that Openreach Co would not create security over its assets would assist in providing the Trustee with some comfort with respect to the risks of Openreach Co assets not being available to the Scheme on a priority (or at least an equal) basis on an insolvency. However we query whether a negative pledge that is sufficiently restrictive to give comfort to the Scheme would be compatible with the long term objective of achieving co-investment and similar models for Openreach Co's business, which will likely involve some form of proprietary interest being taken in Openreach Co's assets by co-investors or joint venture financiers.

5.13 In summary, therefore: while all of these measures may be helpful in addressing the Trustee's concerns around structural subordination, we question the extent to which security or a workable negative pledge and guarantee structure in relation to a pension funding shortfall of up to £[CONFIDENTIAL]bn would be deliverable in practice without prejudicing, perhaps materially, the ongoing business operations of the BT Group (and thereby the Employer Covenant). With respect to a guarantee, without an independent obligation on Openreach Co to make payments to the Scheme as a primary obligation (without any requirement for there to have been a prior demand on, and failure of, BT plc to make the same), there would be no mitigation of the Trustee's loss of direct access to Openreach cash to meet BT plc's funding obligations on a going concern basis. None of guarantees, security or negative pledges assist in mitigating the other risks identified by the Trustee, including the ongoing regulatory uncertainty.

Obligation to upstream cash

5.14 The positive undertakings mooted by the Ofcom Proposal include "*a minimum cash contribution [from Openreach Co] to British Telecommunications plc, to allow BT to meet BTPS contributions*".[38] This would go some way to addressing not merely the structural subordination issue but also potentially the alienation of cash flows.

5.15 However, this obligation would not be provided directly to the Scheme. It is difficult to envisage the form such a direct obligation to make funding contributions would take absent Openreach Co becoming in some way directly liable for part of the Scheme deficit (which may be impossible in practice given the complexity surrounding issues such as the Crown Guarantee), and the Ofcom Proposal does not consider this issue.

5.16 To a lesser extent, knowledge of an obligation to make such payments may also help to address the governance issues by encouraging the Openreach Board to factor Scheme contributions into their budgetary calculations and submission. There are however a number of potential issues that the Trustee has identified with this. In particular:

(i) it is not clear on what timescale and with what degree of certainty the obligation to make any such payments would be founded; would this be fixed at the outset of each

[38] Paragraph 5.21.2 of the Ofcom Document.

new funding agreement, or would it be capable of being varied in accordance with the Trustee's perception of changing funding needs in the underlying Scheme? If fluctuating, how would the independent Openreach Board factor this in to their budget?

(ii) would BT plc have an obligation to make good any shortfall in Openreach Co's budget to compensate for payments Openreach Co is obliged to make to the Scheme?

(iii) how would any co-investors in joint projects get comfort that funds invested for the purposes of co-investment would not be available for the making of any such payments up to BT plc in respect of its pension funding obligations, or directly to the Scheme?

5.17 Similarly, it is not clear what priority Openreach Co would be expected to give to such payment obligations in the context of its wider duties to prioritise improvement of its network. The Trustee considers the uncertainties around this mitigation to be too great in the context of a pension funding shortfall of up to £[CONFIDENTIAL]bn.

5.18 Finally, there is the question of the method by which cash might be upstreamed from Openreach Co to BT plc. Such arrangements would be subject to approval by the Openreach Board in the context of their duties, taking into account the amount of available cash and Openreach Co's other actual and contingent liabilities. While a positive undertaking to upstream cash would be helpful to the Trustee in assessing the Employer Covenant, there are numerous complications and practical issues that render such an arrangement inferior to the current structure of having Openreach cash and cash flows directly embedded in BT plc. A more effective mitigant (and a way of avoiding the potential pitfalls around cash upstreaming) would be to put in place direct payment obligations as between Openreach Co and the Scheme without BT plc as an intermediary but, as set out in paragraph 5.15 above, the mechanism by which this might be achieved is uncertain.

Direct joint and several liability

5.19 The closest possible way to replicate the access and support currently enjoyed by the Trustee with respect to Openreach would be to create a covenant to pay in favour of the Trustee. This would make Openreach Co directly jointly and severally liable for all obligations of BT plc with respect to the Scheme, both with respect to the satisfaction of ongoing payment obligations under the 2014 Funding Agreements (and any extension or replacement of the same) and for liabilities to the Scheme arising more generally from time to time.

5.20 In practice, however, there would be serious challenges to creating such an arrangement. Given the size of Scheme liabilities, it is uncertain whether the Openreach Board would be in a position to assume such obligations without breaching its duties or rendering Openreach Co balance sheet insolvent (and potentially cash flow insolvent should the Trustee ever look directly to Openreach Co for the entirety of a particular funding payment). There is no indication at present on what basis the Openreach business would be transferred to Openreach Co but if this created an intra-group liability from Openreach

Co to BT plc equivalent in value of Openreach's assets, these solvency issues would be particularly acute.

5.21 How such an arrangement would work in practice and how the relative contribution obligations would be structured as between BT plc and Openreach Co would be extremely complicated and potentially the subject of extensive negotiation between BT plc and the Openreach Board. Given the scale of liabilities and the ongoing drain on liquidity this arrangement would impose on Openreach Co, we would also query whether this would be consistent with the underlying objective of the Ofcom Proposal, which is for Openreach Co to have increasing independence and access to agreed funding.

5.22 Finally, there is the potential effect on the Crown Guarantee. There is the potential, however remote, for any arrangements creating joint and several liability to call into question the scope, interpretation or application of the Crown Guarantee by the introduction of third party liability for Scheme obligations. This involves complex issues of public and private law without obvious precedent on a matter already extensively litigated, and any uncertainty as to the ultimate legal effect might be unacceptable to the Trustee. While agreement could in principle be sought with Government that the operation and effectiveness of the Crown Guarantee would remain unchanged, past experience suggests obtaining appropriate assurances from Government would be difficult and the process could, of itself, present risks to the Scheme, [CONFIDENTIAL

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Access agreement with respect to Openreach assets

5.23 As noted in paragraph 4.9, the Trustee believes that the transfer of Openreach assets as part of a legal separation could have a significant negative impact on the strength of the Employer Covenant as such a transfer would mean that the Scheme's access to those assets would be structurally subordinated to the claims of Openreach Co's creditors. We are particularly concerned about the transfer of the copper and fibre lines, buildings, underground ducts and telegraph poles, as well as the Openreach brand (given the value of these assets), although the relocation of any assets from BT plc to Openreach Co would leave the Scheme worse off than it is today.

5.24 Ofcom has expressed its willingness to "*consider alternative mechanisms to secure Openreach access to these assets that delivered…operational control and investment incentives*",[39] including where a transfer of assets raises pension cost risks. Based on the advice that it has received, the Trustee believes that it would be possible for Openreach Co to be granted access to, and operational control of, the Openreach infrastructure assets while ownership of those assets remains with BT plc. For example, an access agreement between BT plc and Openreach Co could allow Openreach Co to use and operate all of the Openreach infrastructure assets and related rights.

5.25 However, while these sorts of access arrangements might ameliorate some of our structural subordination concerns, there remains a risk that the contractual rights of

[39] Paragraph 4.80 of the Ofcom Document.

Openreach Co in respect of those assets are such that the assets retain very little value in the hands of BT plc. For example, if the access agreement allowed Openreach Co to block a sale of those assets by BT plc (or its administrator or liquidator) to satisfy BT plc's obligations to creditors (including the Scheme), then the value of such an arrangement to the Scheme would be diminished. Accordingly, any such access arrangements would need to specifically contemplate that the Openreach assets can be sold, charged or otherwise dealt with by BT plc in order to meet its obligations to the Scheme.

Step-in rights

5.26 Ofcom proposes that its legal separation model would include a right for the BT Group to step in to Openreach Co's business in a "*defined list*" of "*exceptional*" circumstances, including where there has been "*major underperformance by Openreach Board that exposes BT Group to significant risks*" and "*extreme performance issues outside of Openreach…that challenge BT Group's overall financial viability and require access to Openreach cash or assets*".[40]

5.27 The Ofcom Document does not explain what form these step-in rights might take, and whether these would be "strong" step-in rights (e.g. a right to change the Openreach Board such that it has a majority of non-independent directors, a right to unilaterally change the "financial envelope" and the associated Openreach business plans and budgets, or a right to require Openreach Co to make an immediate advance of cash to BT plc by way of loan or dividend) or "weaker" step-in rights (e.g. a right to require Openreach Co to negotiate amendments to the "financial envelope" or the associated business plans and budgets).

5.28 In order for the Trustee to conclude that step-in rights would mitigate the Scheme's concerns in any meaningful way, we would need more detail about the proposed step-in mechanism(s). For the step-in rights to provide much comfort:

(i) the "defined list" of situations that trigger those rights should explicitly include circumstances in which BT plc requires access to Openreach's cash resources and/or assets in order to satisfy its obligations to the Scheme (in particular, the step-in rights should not require a BT plc insolvency or for the BT Group to take unreasonable steps to realise cash from other sources);

(ii) the step-in rights themselves should be "strong" ones such that BT plc would be able to gain access to Openreach's cash (or realise cash by selling Openreach's assets) in a timely manner; and

(iii) the duties of the Openreach Board to have regard to the Customer Purpose and the Regulatory Purpose should not operate to constrain the exercise of the step-in rights.

[40] Paragraphs 4.65 and 4.66 of the Ofcom Document.

Amendments to the Openreach governance arrangements

5.29 For the reasons explained at paragraphs 4.30-4.34, the Trustee believes that the Openreach governance arrangements set out in the Ofcom Proposal would result in Openreach decision-makers having less regard to Scheme-related obligations than at present. We recognise that such governance arrangements are a cornerstone of the Ofcom Proposal, but we believe that those arrangements are likely to have a significant negative impact on the Employer Covenant.

5.30 To address this issue, Ofcom's proposed governance arrangements would need to be amended to include an explicit requirement for the Openreach Board to have regard to the BT Group's obligations to the Scheme, alongside the Customer Purpose, the Regulatory Purpose and the Shareholder Benefit Purpose. While we acknowledge that it would be uncommon for a company's articles of association to include a specific requirement to consider pensions-related obligations, we also note that:

(i) it is unusual for a company's articles of association to require its directors to have regard to its customers and/or its regulatory obligations; and

(ii) the Scheme's size, the scale of its associated costs and the detrimental consequence of the Ofcom Proposal on the Scheme are such that uncommon measures are appropriate.

5.31 To provide a measure of redress to the alienation of cash flows issues raised at paragraphs 4.15-4.27 above, the articles of association of Openreach Co should also require the payment of dividends whenever legally permissible (i.e. whenever there are distributable reserves).

5.32 We also believe that there should be an explicit requirement for the BT Group to consider Scheme-related obligations when approving Openreach's "financial envelope".

5.33 It may be that some of the specific questions around governance that we have identified could be resolved through such mechanisms, and the inclusion of these types of provisions would in our view be necessary. However, we would not regard adjustments to the governance arrangements as a solution in itself to the significant concerns raised by the Ofcom Proposal as explained in this submission.

Service agreement dealing with employees

5.34 As set out in paragraphs 4.38-4.42, there would be significant difficulties associated with a transfer of employees from BT plc to Openreach Co. Without complete prior confidence that the Crown Guarantee has been appropriately extended, the Trustee would be unable to agree to the introduction of Openreach Co as a participating employer of the Scheme. Consequently, any Openreach Co employees who are currently active members of the Scheme would cease to accrue benefits in the BTPS.

5.35 The Ofcom Document states that where "*it is not possible or desirable to transfer employees given the potential associated costs, [Ofcom] would explore alternatives such* *as employee service agreements*" whereby "*BT plc employees are contracted to work for and on behalf of Openreach*".[41] While such an approach might address certain issues from the BTPS's perspective, we believe there could be significant industrial relations issues, which could of course raise challenges for the Employer Covenant.

Extension of the Crown Guarantee

5.36 The application of the Crown Guarantee is complex and has been the subject of substantial and difficult litigation, during which it has been evident that Government holds a materially different expectation of the Crown Guarantee than the Trustee and has sought repeatedly to limit its scope. Separately, the Crown Guarantee has been the subject of litigation in the European courts, in respect of whether the Crown Guarantee, and related provisions, constituted unlawful State aid.[42] In the State aid litigation the ECJ upheld the decisions of the Commission and General Court, finding that the Crown Guarantee did not constitute unlawful State aid because the Crown Guarantee only benefited employees upon the event of BT plc's winding up, and it was not apparent that the Crown Guarantee conferred any advantage on BT plc (e.g. by way of lower pension costs).

5.37 The Trustee is concerned that any changes to the Crown Guarantee could disturb these established positions of law – in respect of the liabilities covered by the Crown Guarantee, and the fact that the Crown Guarantee in its current form (and as currently regarded by BT plc and the Scheme) has been found not to constitute unlawful State aid.

5.38 In any event, we see no evidence that matters relating to the Crown Guarantee could be resolved satisfactorily with Government before the establishment of Openreach Co, particularly if new legislation is required. The uncertainty that would prevail while discussions as to the Crown Guarantee were taking place would likely result in an unacceptable level of risk for the Trustee. Until this uncertainty was resolved to the satisfaction of the Trustee, it would be unable to permit Openreach Co to become a participating employer, resulting in Openreach Co employees becoming deferred members and losing future accrual, for what could be an indefinite period of time. Ofcom states that the Crown Guarantee is a matter for Government and that Ofcom will have further discussion with Government directly on this issue. However, the Crown Guarantee is a critical matter for the members of the Scheme, and therefore the Trustee as a representative of these members' interests. It would not be acceptable to seek to resolve any matters regarding the terms of the Crown Guarantee without Trustee involvement.

5.39 Given the complications associated with any attempt to amend the terms of the Crown Guarantee, the Trustee would have significant concerns with any attempt to force BT plc to transfer employees who are members of the Scheme to Openreach Co.

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[41] Paragraph 4.74 of the Ofcom Document.

[42] British Telecom v The European Commission [2013] Pension. L.R. 359 (16 September 2013) (General Court); British Telecom v The European Commission, Case 620/13 P (22 October 2014) (ECJ).

Non-compete provision

5.40 The Ofcom Proposal contemplates that "*a non-compete agreement between BT and Openreach could be put in place*",[43] although little detail is provided about the nature of these arrangements. We assume the intention of a non-compete provision would be to ensure that competition between the residual businesses of the BT Group and the business of Openreach Co does not lead to a lessening of the value of the BT Group taken as a whole. It is not clear if the non-compete obligation would only bind Openreach Co or if Ofcom also envisages a reciprocal non-compete undertaking from the rest of the BT Group, but we note the latter option would put the other BT Group businesses in a worse position than their competitors.

5.41 For this to be effective, the terms of the non-compete agreement would be key. The Ofcom Proposal envisages co-investment projects between Openreach Co and other communications providers, and specifies that any non-compete should be subject to these joint ventures. However, the prospect of Openreach seeking to grow a separate business line organically in competition with the rest of the BT Group, other than as part of a joint venture with another communications provider, seems remote. On this basis, a non-compete provision as proposed by Ofcom seems unlikely to be an effective protection to any negative impact on the health of the BT Group from internal competition.

Protections contained in the 2014 Funding Agreements

5.42 As discussed in paragraph 4.35, the Trustee relies on certain information and consultation undertakings given by BT plc in the 2014 Funding Agreements. BT plc and BT Group plc have also given undertakings restricting the granting of certain security interests by any member of the BT Group.

5.43 These undertakings would need to be revised, probably with Openreach Co added as a party, in order for the Scheme to remain in the same position that it is in today. Given that the Ofcom Proposal contemplates that the Openreach Board will act independently of BT plc, there can be no certainty that it will agree to be bound by the terms of the 2015 Agreements or, if it does not agree to be bound, that BT plc will be able to procure that the undertakings will be complied with.

5.44 In addition to the undertakings described above, in some circumstances the 2014 Funding Agreements require an additional contribution to be made to the Scheme where net disposals by BT plc exceed a threshold. To ensure that the Scheme's position is not prejudiced, the 2015 Agreements will need to be amended to also take into account net disposals by Openreach Co.

Increased cash contributions

5.45 It would, of course, be possible for the Trustee to call a valuation to reassess the funding position of the Scheme in light of the changes in the Scheme's risk profile if Ofcom proceeds with its proposals. As set out previously in this paper, the Trustee considers

[43] Paragraph 5.21.4 of the Ofcom Document.

that the outcome of such a valuation would most likely be a materially higher deficit and an urgent need for immediate substantial cash contributions to the Scheme. This would clearly have consequences for BT plc which we suggest Ofcom would need to consider when assessing the proportionality of the Ofcom Proposal and the potential impact on the funds BT plc would have available to support innovation and investment in ultrafast broadband and network infrastructure. It should be noted that the results of any valuation undertaken by the Scheme Actuary would require detailed work and analysis reflecting any developments in the Trustee's ongoing investment strategy, and would be subject to the outcome of negotiations and discussions with BT plc.

Summary

5.46 Overall, although some of the mitigants could have an impact on the risks faced by the Scheme, none of the non-cash approaches, alone or in combination, would mitigate fully the increased risk to the Scheme resulting from the Ofcom Proposal. Consequently the Trustee would be likely to seek a material increase in cash contributions which is likely in turn to have adverse consequences for BT plc, and reduce the funds available for infrastructure investment. Furthermore, we foresee considerable difficulties in obtaining many of the mitigants and, in many instances, the arrangements would of themselves introduce further risk due to their inevitable complexity and future uncertainty. To place the Scheme in the same position as it is in today from a recourse perspective, the Trustee would require nothing less than to have an unlimited primary joint and several obligation on Openreach Co co-extensive with any and all of BT plc's obligations and liabilities to the Scheme, structured so as to in no way compromise the Crown Guarantee. However, such a mechanism would still not adequately mitigate the commercial and financial effects of the Ofcom Proposal.

5.47 As mentioned above, even assuming that Openreach Co is able to assume such a joint and several obligation without rendering itself immediately insolvent on a balance sheet basis (and potentially on a cash flow basis if the Trustee were then to call on Openreach Co to satisfy the majority or all of the payment obligations falling due under the then current funding agreement), we foresee considerable difficulties in obtaining such appropriate mitigation and are concerned that in itself it may be detrimental to the long term Employer Covenant. This is discussed in more detail in section 6 below.

6. CHALLENGES IN OBTAINING APPROPRIATE MITIGATION

6.1 Even if a combination of the mitigants considered in section 5 above has the potential to address the Trustee's primary concerns, there are real challenges to obtaining many of those mitigants that must be taken into account by Ofcom.

6.2 Ofcom recognises that guarantees, securities, negative pledges and the other arrangements considered "*are likely to be highly detailed and complex. They would need to be reached via detailed negotiation between BT and the BTPS trustees*".[44] Negotiations may also be required with Government, for example, in respect of the Crown Guarantee.

6.3 In any such negotiations, we are mindful that BT plc will be obliged to have regard to the interests of all its stakeholders and that the interests of BT plc and the Government will not necessarily align with the interests of the Scheme. The Trustee would therefore need to take a prudent and cautious approach and would be unable to anticipate securing a favourable outcome at any point prior to the conclusion of such negotiations.

6.4 Even if BT plc wanted to take action to reduce the risks to the Scheme of the type discussed in section 5, we expect BT plc would face numerous commercial challenges in doing so. For example:

(i) as described at paragraphs 4.12 and 5.7 above, BT plc lenders, bondholders and other third party creditors (consent from at least some of whom may be needed if BT plc were to transfer a substantial part of its business to a new company) will have similar concerns to the Trustee with respect to security and structural subordination. They can be expected to look for Openreach Co guarantees, and to resist the introduction of security that has the effect of preferring the Trustee's claims to their own;

(ii) negative pledges, borrowing, guaranteeing and similar constraints on Openreach Co could be resisted by the independent Openreach Board, as they will constrain its operational and financing flexibility;

(iii) implementation of a comprehensive security package over a large number of assets (including many small leasehold and freehold properties) would be very complex, and could impose significant ongoing costs on Openreach Co and constrain its operational and financing flexibility; and

(iv) the complexity of this package of mitigants may impede future initiatives and commercial developments by BT plc and/or Openreach Co.

6.5 Commercial challenges such as those outlined at paragraph 6.4 above would also be of concern to the Trustee. It is important for the ongoing security of the Scheme that the BT Group is able to raise finance so that it can fund its obligations to the Scheme out of more than just the cash flow generated from its business. Maintenance by the Trustee of its

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[44] Paragraph 5.22 of the Ofcom Document.

legal access to Openreach revenues and assets is of limited value if the broader value of the Employer Covenant is impaired.

6.6 These challenges in agreeing and implementing the mitigants result in significant uncertainty for the Scheme. Additional uncertainty and damage to the Employer Covenant results from:

(i) the time it would take to reach a resolution. In this respect, the sequencing of events is crucially important. If Ofcom were to proceed with its proposal, while leaving BT plc and the Trustee to work out any necessary mitigants, then given the scale of the funding shortfall, the Trustee may need to start work immediately on a valuation of the Scheme as a contingency matter in case it is not possible (perhaps for reasons outside BT plc's reasonable control) to finalise a mutually acceptable and workable package of mitigants. This could of course be destabilising for BT plc, which could in itself weaken the Employer Covenant in a way that leaves the Trustee no option but to follow through on a significant de-risking of the Scheme and accelerating the process of recovering what may be a significantly increased funding shortfall;

(ii) the complexity of the arrangements, which creates an inherent risk of reinterpretation at a later point, as demonstrated by the history of complex litigation in respect of the Crown Guarantee. The issues that arise in the Ofcom Proposal are highly complex. It cannot be assumed that all stakeholders will interpret the Ofcom Proposal and any consequential mitigants in the same way, particularly as years go by – it may be hard to avoid the conclusion that a new "synthetic" structure is inherently less flexible and reliable than the current structure. This complexity is compounded by the size of the Scheme; and

(iii) inevitable conflicts of interest between the interests of the Scheme and the interests of BT plc shareholders, customers and creditors.

6.7 To the extent that there are uncertainties or increased risks, or the Employer Covenant is otherwise weakened in a way which cannot be fully addressed by all or any of the proposed non-cash mitigants, the Trustee may consider itself bound to reflect the relevant concerns in the Scheme's funding target and/or recovery plan. It should be noted in this context that, given the size of the Scheme, even a small change in the prudence margins over and above the prudence margins in the 2014 assumptions could trigger a requirement for substantial additional cash payments from BT plc.

6.8 Pension costs are key to an overall assessment of whether the costs of the Ofcom Proposal are proportionate to their aims. The Trustee therefore considers it essential that the various elements of any package of mitigation are not assumed. Mitigants that have been agreed by both BT plc and the Trustee, and any resolution reached between Government and the Trustee regarding the Crown Guarantee (including any legislative consequences), should instead form an integrated part of the Ofcom Proposal before its true costs can be assessed and its appropriateness determined. They must be "baked in", with any necessary third party consents obtained and details agreed, before any final decision is taken to proceed.

6.9 For all of these reasons, the Trustee has concerns about the potential order of events should Ofcom seek to implement the Ofcom Proposal, or some variation of it. In particular, the Trustee is concerned that Ofcom might reach a final decision, assuming that arrangements for mitigation can be reached between BT plc, the Trustee and Government after the fact. The Trustee urges Ofcom to recognise the challenges in obtaining any appropriate mitigation.

7. CONCLUSIONS ON POTENTIAL IMPACT OF OFCOM PROPOSAL

7.1 For the reasons set out in this paper the Trustee's view, after careful consideration of the proposals and in light of the advice that it has received, is that Ofcom is correct to have had concerns that the Ofcom Proposal could increase the risks facing the Scheme. The Trustee's conclusion is that the Ofcom Proposal in its current form would have a material impact on the confidence of the Trustee in the Employer Covenant and the security it provides to the Scheme both today and in the future.

7.2 Although some of the mitigants could have an impact on the risks faced by the Scheme, none of these approaches, alone or in combination, would mitigate fully the increased risk to the Scheme resulting from the Ofcom Proposal.

7.3 Furthermore, it would be difficult for the Trustee to accept a position where the Ofcom Proposal had been mandated by Ofcom without terms of mitigation having been expressly pre-agreed. Mitigants would be the subject of negotiation with BT and Government. In any such negotiations, BT plc will be obliged to have regard to the interests of all its stakeholders and that the interests of BT plc and the Government position will not necessarily align with the interests of the Scheme. The Trustee would be unable to anticipate securing a favourable outcome at any point prior to the conclusion of such negotiations.

7.4 In any event, mitigants would of themselves introduce further risk due to their inevitable complexity and future uncertainty resulting in potential commercial strain and risk. In addition, the ongoing nature of regulatory review creates uncertainty over the future support provided by BT plc to the Scheme and raises concerns with placing long term reliance on the Employer Covenant.

7.5 Anything that increases the risks facing the Scheme, including a diminution in the value or resilience of the Employer Covenant, would require the Trustee to take a more cautious approach to the funding of the Scheme. The Trustee would need to consider in detail, and in light of the wider economic circumstances, the appropriate response. Given the potential for material detriment to the Employer Covenant as a result of the Ofcom Proposal, the lack of confidence that adequate viable mitigants can be found and the ongoing uncertainty that this would create, the Trustee would, among other things, be likely to:

(i) call an immediate formal actuarial valuation to ensure the Scheme's funding needs are established and a revised legally binding schedule of contributions put in place with BT plc before any such detriment occurs. Any valuation would reflect the Trustee's concerns regarding the ongoing stability of the Employer Covenant and any actual or anticipated revisions to the Trustee's ongoing investment strategy;

(ii) consider the immediate and longer term cash funding needs of the Scheme. This could result in a revised schedule of contributions that requires substantially higher contributions from BT plc in the near term, to stabilise the funding position of the Scheme and reduce reliance on the Employer Covenant. This consequence of Ofcom's actions could also result in the Scheme's funding needs consuming a substantial portion of BT's free cash flow;

(iii) modify the Scheme's current investment strategy (following consultation with BT plc) to reduce the current level of risk in line with the perceived weakening in the Employer Covenant. This would reduce the investment return expected from the Scheme's assets leading to an increase in the Technical Provisions; and/or

(iv) accelerate the time frame over which the Scheme plans to achieve its target low risk portfolio and possibly lowering the level of risk within that long term portfolio. These changes would lower long term return expectations and increase Technical Provisions.

7.6 Based on our current understanding of the Ofcom Proposal, the Trustee believes it could result in significant detriment to the Employer Covenant and this would necessitate the Trustee taking a less risky approach. The advice received from the Scheme Actuary indicates that this, on a standalone basis and without mitigation, could result in an increase to the Technical Provisions deficit to above £[CONFIDENTIAL]bn, materially increasing the Scheme funding burden faced by BT plc.

7.7 In considering the proportionality and merits of its proposals, Ofcom should therefore, in our view, factor in the potential for material additional pensions costs as a result of the impact of these proposals on the position of the BTPS. Such costs would in turn inevitably impact on the ability of BT plc and the wider BT Group to invest in other areas of its business.